R&D Tax Credit Can Turn R&D Investment into Cash

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Thursday, February 18, 2010

Reprinted from *R&D Magazine* online

In today's lackluster economy, businesses have become more cash-conscious, and every dollar of income earned and saved is important. Typically, the top three business expenses are wages, raw materials, and taxes. If you cut jobs or reduce purchases, you may increase profitability in the short term. But over time lack of inventory and the inability to manufacture more products can prove to be costly, especially as the economic downturn begins to show signs of recovery.

One truly benign way of cutting costs is reducing the tax burden. In industries from chemicals to software, from agriculture to fashion, and at every level, taking full advantage of a tax credit provided by the federal and many state governments to encourage innovation and competitiveness—the R&D tax credit—enables companies to achieve remarkable tax savings.

Who's Eligible?

As a firm devoted to helping businesses take full advantage of this credit, we took a close look at companies with which we have worked recently to understand why they either had not been taking this credit before coming to us, or had been under-utilizing it. Most of these companies knew or suspected that they were eligible for the R&D tax credit, but they did not understand exactly what activities qualify and how much money was actually at stake.

The statutory and regulatory changes to the R&D tax credit over the past eight years are often the source of the problem. The various changes led companies' financial advisors to either qualify only new product or process development, or to not claim any credits whatsoever for their clients. This misunderstanding is largely due to the outdated notion of the discovery rule.

Under the discovery rule, to claim the credit, a product or process had to be revolutionary. This is no longer true. In fact, improved products and processes now qualify along with new ones, as long as the process requires experimentation to overcome any uncertainties. This is a much broader definition and allows many more activities to be covered under its umbrella.

In addition to allocating R&D resources beyond the realm of patentable inventions, many companies outside of the Fortune 500 do not keep detailed accounts of R&D activities. Moreover, for many smaller companies, implementing such a system is cost prohibitive.

Case Studies from Various Industries

These case studies illustrate the point that many types of businesses may qualify to take advantage the R&D tax credit and, at the same time, explore how the credit actually works.

Chemicals

A chemical industry client was not taking advantage of the R&D tax credit. After an initial discussion, it was clear that the client's prevailing mindset in terms of the credit was to focus only on new formulation development and improvements to existing formulations to improve product performance. This approach allowed them to capture only the wages from the R&D department and the raw materials used to produce prototypes, about $250,000 in tax savings. However, after additional review and conversation, we identified two additional areas for capturing R&D costs:

1. Manufacturing process improvements (wages of the company's manufacturing engineers and process development personnel), and
2. Test method development (wages of laboratory personnel who were not only experimenting to perfect these methods, but were also running tests to evaluate experimental formulations).

Both of these activities were essential to this business's survival, to ensure product quality in a competitive market with increasing regulatory pressure. The manufacturing and process personnel continuously evaluated changes to increase production throughput and decrease products made out of specification. Furthermore, new testing methodologies were required to ensure products adhered to enhanced quality standards to protect consumers. Even though both activities were conducted to keep the company in business and competitive (and not specifically to bring something new to market), they still met the statutory definition of R&D.

By finding these additional sources of qualified expenditures, the client's annual R&D tax credit more than doubled to approximately $500,000 in tax savings.

Biomedical Devices

A biomedical device developer used extant technology to design and develop new and improved medical device products that met the requirements of specific applications. The company believes (incorrectly) that to qualify for the credit, R&D activities must be related to projects and employee activities that resulted in a revolutionary design that is new to the industry. An analysis of the manufacturer's projects and activities revealed approximately $500,000 of net federal and state R&D tax credits. These refunds enabled the company to invest in hiring additional engineers and purchasing new equipment for research.

Engineering Services

A nationwide engineering service firm that provides a variety of structural, geotechnical, civil, and environmental engineering services understood that it regularly conducted qualified research activity, and had sought the assistance of a large international accounting firm for several years to claim available federal and state R&D tax credits. Although the accounting firm was knowledgeable in the relevant laws and regulations, it lacked the industry expertise to fully understand the engineering firm's projects, job costing system, and engineering docu-

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mentation. As a result, it was unable to fully assess the thousands of projects that the engineering service firm conducted during the course of a year, resulting in a dramatic under-utilization of the credit. Only a handful of the larger foundation and structural design projects were identified and qualified for the credit. An analysis revealed a large number of smaller projects that also included qualifying research activities. Ultimately, this engineering firm was able to achieve federal and state tax savings in excess of $1 million.

Healthcare Software Development

A developer of software applications for the healthcare industry employs teams of programmers who develop products and perform quality assurance tests. It also employs analysts, project managers, and executives who assist in the concept development and testing of these applications, as well as supporting and supervising the teams.

The R&D credit requires that taxpayers satisfy four requirements, or tests, to qualify. First, you must develop a new or improved business component (e.g. software). Second, your work must be technological in nature. Third, there must be uncertainty. And, finally, you must engage in a process of experimentation. Let's take a quick look at each of these requirements as it applies to this company.

New or improved business components.

The R&D tax credit defines six business components. They include a product, process, technique, invention, formula, and software. The business components have to be either held for sale, lease, or license, or they have to be used in your trade or business. Another caveat to this test is that the research must be aimed at developing a new or improved function, performance reliability, or quality. The software developer was enhancing existing software to improve its processing ability, expand the types of data that the system could handle, and improve the software's ability to monitor and alert doctors to issues relative to their patients. These improvements were for a permitted purpose. Conversely, the development or tweaking of the user interface, which related primarily to style or taste, was not eligible for the credit.

Technological in nature. The next test is whether the activities are technological in nature. If programming relies upon principles of computer science, this requirement is satisfied. This test requires examination of the development process to determine if the research relies on principles of physical or biological sciences, engineering, or computer science. If the research is related to one of those areas, it is deemed technological in nature. Obviously, the healthcare software company's software development was based upon principles of computer science and would, therefore, qualify.

Uncertainty. So long as there exists some uncertainty as to whether the new or improved piece of software can be developed, how the software will be developed, or what the appropriate design of the software will be, development will satisfy the uncertainty test. In software development, uncertainty is almost everywhere. The healthcare software company was uncertain regarding the architecture of the software. Additionally, many revisions were required in order to design the most efficient workflow in the applications and determine how new features should best be integrated.

Process of experimentation.

By the book, this means you have to engage in a process of evaluating alternatives designed to eliminate uncertainties in the development process. Software development is inherently a process of experimentation. The healthcare software company went through this process numerous times with every improvement in its software. As issues were identified, developers tracked their resolutions in a defect database. When stable versions of the applications were achieved, a team of quality assurance analysts tested them thoroughly to ensure each module retained individual functionality while still functioning as part of the whole. Since they participated in concept development, testing, and programming activities whereby they were eliminating alternative design approaches, the company's development path constituted R&D activities.

Conclusion

With the current economy, it is ever more important for businesses to explore every avenue of tax savings, and with more than 7,000 federal and state tax credits and incentives available, failing to pursue them aggressively simply doesn't make sense. A financial advisor or specialty firm can make sure that your business is taking full advantage of the R&D tax credit.

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